IN THE UNITED STATES BANKRUPTCY COURT

FOR THE DISTRICT OF IDAHO

IN RE	)	
	)	**Case No. 96-03050**
SAWTOOTH ENTERPRISES, INC., d/b/a The Buckin' Bagel,	)	
	)	
Debtor.	)	
_____	)	
	)	
BERNIE R. RAKOZY, Trustee,	)	**Adv. No. 98-6330**
	)	
Plaintiff,	)	**MEMORANDUM OF DECISION RE MOTIONS FOR SUMMARY JUDGMENT**
	)	
vs.	)	
	)	
AMERICAN FORMS & LABELS, INC.; et al.,	)	
	)	
Defendants.	)	
_____	)	

Jed W. Manwaring, EVANS, KEANE, Boise, Idaho, for Plaintiff.

Alan D. Cameron, BEVIS, CAMERON & JOHNSON, Boise, Idaho, for Defendant Black Bear, Inc.

David E. Wishney, Boise, Idaho, for Defendant Sonna Building Associates.

Background

In this adversary proceeding, Plaintiff, Chapter 7 trustee Bernie R. Rakozy (hereafter "Trustee"), seeks to avoid and recover several payments

made by Debtor Sawtooth Enterprises, Inc. d/b/a The Buckin' Bagel to several of its suppliers before bankruptcy as preferences under Section 547(b) of the Bankruptcy Code. Before the Court for disposition are the motions for summary judgment filed by Defendant Sonna Building Associates ("Sonna") and Defendant Black Bear, Inc. ("Black Bear"), and by Trustee. Following a hearing on September 30, 1999, the matter was taken under advisement.

Facts

The following are the undisputed material facts.

Debtor filed for bankruptcy protection under Chapter 11 of the Bankruptcy Code on November 27, 1996. The case was converted to Chapter 7 on March 13, 1997, and Mr. Rakozy was appointed to act as trustee.

Defendant Black Bear owns commercial property in Ketchum, Idaho which at the time of the bankruptcy filing was leased to Debtor. Debtor paid Black Bear $2,033.82 on November 7, 1996, for Debtor's October and November 1996 rent.

Defendant Sonna leased Debtor a building in Boise, Idaho in November 1994. Debtor made several lease payments to Sonna shortly before the bankruptcy: (1) $3,846 on October 8, 1996 for the August 1996 rent; (2)

$3,848 on October 9, 1996 for September 1996 rent; (3) $3,196 on October 22, 1996 for the October 1996 rent; and (4) $3,846 on October 22, 1996 for accrued late fees.

During the Chapter 11 case, on December 24, 1996, Debtor filed a motion with the Court seeking authority to assume the Black Bear and Sonna leases, and to assign the leases to a third party. Black Bear and Sonna objected to the motion, but these objections were later resolved through negotiations with Debtor. As a result, on January 23, 1997, the Court entered an order with the consent of the parties authorizing Debtor to assume the Black Bear and Sonna leases, and to assign those leases to the third party. The order contained agreed terms concerning the cure of existing lease defaults and providing assurances for the future performance of the leases.

Trustee seeks to recover the prebankruptcy payments made by Debtor to Black Bear and Sonna identified above as preferences.

Applicable Law

Summary judgment is appropriate if, after viewing the evidence in the light most favorable to the non-moving party, there are no genuine issues of material fact remaining and the moving party is entitled to judgment as a matter

of law. Fed. R. Bankr. P. 7056; *State Farm Mutual Automobile Insurance Company v. Davis*, 7 F.3d 180, 182 (9th Cir. 1993); *FSLIC v. Molinaro*, 889 F.2d 899, 901 (9th Cir. 1989).

Discussion

Under Section 547(b), a transfer of an interest in property of the debtor may be avoided as a preference if the transfer: (1) is to or for the benefit of the creditor; (2) is for or on account of an antecedent debt owed by the debtor before such transfer was made; (3) is made while the debtor was insolvent; (4) is made within ninety days before the date of the filing of the bankruptcy petition; and (5) enables the transferee to receive a greater amount than would otherwise have been received in a case under Chapter 7 if the transfer had not been made. 11 U.S.C. § 547(b); *Larson v. Timmons (In re Larson)*, 97.3 I.B.C.R. 89, 90. Trustee bears the burden of establishing each element of a preference. 11 U.S.C. § 547(g); *In re R & T Roofing Structures & Commercial Framing, Inc.*, 887 F. 2d 981, 984 (9th Cir. 1989); *Fitzgerald v. FMC Employees Federal Credit Union (In re Petersen)*, 98.1 I.B.C.R. 12.

Here, Defendants concede that Trustee can establish the first four elements of a preference listed above. It is the fifth element, the "greater

amount" test of Section 547(b)(5) that is in dispute. This provision requires the Court to compare the amount received by the creditor via the alleged preferential transfer with the amount the creditor would receive in a hypothetical Chapter 7 liquidation had the alleged preference not occurred. *Elliott v. Frontier Properties (In re Lewis W. Shurtleff, Inc.*, 778 F.2d 1416, 1423 (9th Cir. 1985). In this case, Trustee must show Defendants received more as a result of Debtor's prebankruptcy payments than they would have received in a hypothetical liquidation case.

The starting point in this analysis is to determine the status of the creditor to which the alleged preferential payment was made. *Committee of Creditors Holding Unsecured Claims v. Koch Oil Company (In re Powerine Oil Company)*, 59 F.3d 969, 972 (9th Cir. 1995). The Ninth Circuit Court of Appeals, in *Alvarado v. Walsh (In re LCO Enterprises)*, 12 F.3d 938, 941 (9th Cir. 1993), explained the importance of the creditor's status when recovery is sought of payments made to a debtor's lessor:

> In an ordinary case, the amount and priority of an unsecured creditor's claim is fixed on the date of the filing of the petition. Similarly, on the date of the filing, a secured creditor's claim is fixed in amount, the value of the security as of that date can be ascertained and the claim will be either fully or partially secured. The debtor's lessor, however, stands in a different position. Although the amount of

> the debtor's prepetition default under the lease may be fixed on the date of the filing, the status of the lessor's right to payment from the estate is not yet fixed. That is because the lessor's position relative to other creditors depends on whether the lease is assumed or rejected. If the lease is assumed, the lessor is entitled to prompt payment in full of any default under the lease, and the debtor is entitled to continued use of the property. 11 U.S.C. § 365(b). If the lease is rejected, the lessor is entitled to immediate possession of his property and holds an unsecured claim for the unpaid rent.

LCO, 12 F.3d at 941.

The decision of the Ninth Circuit in *LCO* controls the outcome in this instance and instructs that instead of conducting a hypothetical Chapter 7 liquidation analysis based upon the facts as they existed when the bankruptcy petition was originally filed, the bankruptcy court should consider the actual events concerning the parties occurring within the bankruptcy case. 12 F.3d at 942-43.[1] In *LCO*, because the lease in question had been assumed, the trustee

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[1] Were it appropriate to choose the best rule for decision, the Court would perhaps be persuaded by the thoughtful analysis provided in the dissent in *LCO* by Judge Trott. He explains:

> I cannot join the majority's opinion because I think it ignores the text of § 547(b)(5) in its attempt to reach an "equitable" result. If the statute requires a chapter 7 analysis to be conducted in a "vacuum," excluding postpetition events, then into the vacuum we must go. . . . Instead of a bright-line rule evaluating potential preferences as of the filing date of the bankruptcy petition, the majority clouds the analysis with a new exception.

was not allowed to recover prebankruptcy rent payments as preferences. The Court reads *LCO* as holding that, as a matter of law, if a lease is assumed by the debtor during the bankruptcy case, lease payments to the lessor cannot later be recovered as preferences. 12 F.3d at 942 ("The legal effect of [an] assumption is that the rent payments . . . made within the preference period did not operate to improve the [lessor's] position.")

As it was in *LCO*, in this case the preference issue hinges on whether the leases held by Defendants were assumed or rejected during Debtor's bankruptcy case. Under Section 365(b), "[i]f the lease is assumed, the debtor must cure any default." *LCO*, 12 F.3d at 941. When a lease is assumed and the prepetition default cured, "for purposes of the 'greater amount' test, [the creditor] stands in a position similar to that of a secured creditor." *Id.* A transfer to a secured creditor is generally not considered preferential since that creditor is entitled to receive payment of its claim in full and therefore does not receive

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> Now, some postpetition events will be considered, and the liquidation analysis will be conducted on a later date which the court deems appropriate. Analyzing a hypothetical chapter 7 liquidation is hard enough without interjecting uncertainty as to the date of that analysis. I think a good vacuum might help clear away some of the fog.

LCO, 12 F.3d at 946 (Trott, J., concurring and dissenting).

more than it otherwise would in a hypothetical Chapter 7 liquidation. *Powerine Oil Company*, 59 F.3d at 972.

In *Grabscheid v. A & W Products Company, Inc. et al. (In re Club Wholesale Concepts)*, 94 I.B.C.R. 107, 109, this Court, faced with a similar preference issue, refused to speculate whether a Chapter 7 trustee would assume or reject the lease there in question. However, the Court need not speculate in this case since it is undisputed that the leases were actually assumed by Debtor during the Chapter 11 case. In the order entered on January 23, 1997, the Court authorized Debtor to assume both the Black Bear and Sonna leases. That order required Debtor to pay Defendants any and all lease defaults in accordance with Section 365(b)(1) of the Bankruptcy Code. As a result, under the "greater amount" test as interpreted by the Ninth Circuit, Defendants should be treated no differently than secured creditors. Under this test, Defendants would not have received more from the transfer of rent payments than in a hypothetical Chapter 7 liquidation. Because Trustee failed to establish the fifth element of a preferential transfer under Section 547(b)(5), he cannot recover the payments, and Defendants are entitled to judgment as a matter of law.

Trustee argues that Bankruptcy Code Sections 348(c) and 365(d)[2], when read together, offer a trustee, following the conversion of a case to Chapter 7, another opportunity to reject an executory lease already assumed by the debtor in a Chapter 11 case. Trustee cites *Collier on Bankruptcy* and *In re Santos Borrero*, 75 B.R. 141 (Bankr. D. Puerto Rico 1987), in support of this proposition.

In *Santos Borrero*, the debtors, while in Chapter 13, entered into a new lease with their landlord. The case was later converted to Chapter 7 and the issue was whether the newly appointed Chapter 7 trustee could assume or reject the lease. The court pointed out that Sections 348(c) and 365(d) read together provided the Chapter 7 trustee with the "option to either assume or reject a contract entered into by the debtor *in the superseded chapter 13 case* prior to conversion to chapter 7 . . . ." *In re Santos Borrero*, 75 B.R. at 143 (emphasis added). The court also explained that "[t]he interaction of both section 348 and Rule 1019 clearly indicates that actions taken in a superseded case prior to its conversion to chapter 7 are not to be negated." *Id.*

Collier on Bankruptcy provides that:

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[2]Section 348(c) provides, for purposes of Section 365(d), an order converting a case to Chapter 7 is to be treated as the order for relief in the Chapter 7 case. Section 365(d)(4) gives the Chapter 7 trustee 60 days after the order for relief to assume or reject an executory lease of nonresidential real property.

> Sections 348(c) and 365(d) read together indicate that a chapter 7 trustee may assume or reject an executory contract entered into in a chapter 11, chapter 12, or chapter 13 case subsequently converted to chapter 7. Thus, for example, when a lease was not assumed in the chapter 13 case, and after the case was converted to chapter 7 the trustee took no step to assume the lease, the lease was deemed rejected sixty days after entry of conversion order pursuant to § [365(d)].

3 *Collier on Bankruptcy*, ¶ 348.04 (15th Ed. Revised 1996).

The Court reads the court's decision in *Santos Borrero* and the *Collier* excerpts to stand for the proposition that a Chapter 7 trustee may assume or reject an executory lease entered into in a reorganization case prior its conversion to Chapter 7, and that the time period in which the Chapter 7 trustee must act recommences upon conversion. However, the statutes, case law, and *Collier* do not suggest that a trustee can reject a lease that was assumed in the case prior to conversion or assume a lease that had previously been rejected.

In addition, as Defendants point out, here the leases were not only assumed during Debtor's Chapter 11 case, the leases were assigned by Debtor to a third party. *See* 11 U.S.C. § 365(f) (notwithstanding provisions of executory contract or unexpired lease, trustee may assign the contract or lease, if the contract or lease has been assumed and adequate assurance of future performance is provided.) As a result, as of the date the case converted to

Chapter 7, Debtor's interest in the leases was no longer property of the bankruptcy estate. In other words, and regardless of the interpretation given Section 348(c), if the debtor has no property interest in a lease when the case converts, the lease certainly cannot be assumed or rejected by the trustee under Section 365(d). At that point, Defendants' leases were no longer executory contracts for purposes of Section 365(d). An executory contract is one as to which:

> the obligations of both parties are so far unperformed that the failure of either party to complete performance would constitute a material breach and thus excuse the performance of the other.

In re Heward Brothers, 97.2 I.B.C.R. 49 (citing *In re Robert L. Helms Constr. & Dev. Co. Inc.*, 110 F.3d 1470, 1472 n.2 (9th Cir. 1997)). In this case, once the leases were assumed and assigned to a third party, no unperformed obligations remained between Defendants and Debtor. Because the leases were no longer executory, the Chapter 7 trustee could not assume or reject them.

Conclusion

There remain no genuine issues of material fact. Trustee, as required by Section 547(b)(5), cannot establish that Defendants Black Bear and Sonna received more as a result of the lease payments from Debtor than they would have received in a hypothetical case under Chapter 7 had the payments not been made. For the reasons set forth above, the Court will grant the motions for summary judgment of Defendants Black Bear and Sonna, and deny the Trustee's motion for summary judgment.

Counsel for Defendants shall submit an appropriate form of order and judgment for entry by the Court.

DATED This _____ day of November, 1999.

_____
JIM D. PAPPAS
CHIEF U.S. BANKRUPTCY JUDGE

CERTIFICATE OF MAILING

I, the undersigned, hereby certify that I mailed a true copy of the document to which this certificate is attached, to the following named person(s) at the following address(es), on the date shown below:

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CAMERON S. BURKE, CLERK
U.S. BANKRUPTCY COURT

DATED:

By_____
Deputy Clerk